



**DEPARTMENT OF
FINANCE**

ARNOLD SCHWARZENEGGER, GOVERNOR

915 L STREET ■ SACRAMENTO CA ■ 95814-3706 ■ WWW.DOF.CA.GOV

December 28, 2005

Mr. Jerry R. Jolly, Director
Department of Alcoholic Beverage Control
3927 Lennane Drive, Suite 100
Sacramento, CA 95834

Dear Mr. Jolly:

Final Report—Department of Alcoholic Beverage Control Internal Control Review

Enclosed is our internal control final report on the Department of Alcoholic Beverage Control (Department) as of January 6, 2005. The Department of Finance, Office of State Audits and Evaluations (Finance), performed this review in accordance with the Financial Integrity and State Managers' Accountability Act of 1983, to provide the Department with information as to whether controls are established and functioning as intended, to provide Department management with opportunities to correct identified weaknesses, and to improve its operations.

In accordance with Finance's policy of increased transparency, the final report will be placed on the Finance website. We appreciate the assistance and cooperation of Department staff and management during our review. If you have any questions regarding this report, please contact Susan M. Botkin, Manager, or Brandon Nunes, Supervisor, at (916) 322-2985.

Sincerely,

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations

Enclosure

cc: Mr. Dennis Clear, Assistant Director, Administration, Department of Alcoholic Beverage Control
Ms. Karen Broadsky, Fiscal Officer, Department of Alcoholic Beverage Control
Ms. Sunne Wright McPeak, Secretary, Business, Transportation, and Housing Agency

AN INTERNAL CONTROL REVIEW

Department of Alcoholic Beverage Control

Prepared By:
Office of State Audits and Evaluations
Department of Finance

TABLE OF CONTENTS

Preface	iii
Executive Summary	v
Auditor's Report	1
Findings and Recommendations	3
Conclusion	8
Department's Response.....	9

The primary responsibility of the California Department of Alcoholic Beverage Control (Department) is to administer the provisions of the 1955 Alcoholic Beverage Control Act. The Department is vested with the exclusive right and power to license and regulate the manufacture, sale, purchase, possession, and transportation of alcoholic beverages within the state. The Department is organized into the headquarter's office located in Sacramento, two division offices, and twenty-four district offices to address these responsibilities. The Department's funding is generated from liquor license sales and the State General Fund.

While our review focused on the operations of the Department's main office in Sacramento, we did perform testing of the controls over cash receipts and fixed assets at the Santa Ana, San Diego, San Marcos, Lakewood, and Inglewood district offices.

Department management is responsible for the establishment and maintenance of internal and administrative controls. These controls are defined as a process to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting; (b) effectiveness and efficiency of operations; and (c) compliance with applicable laws and regulations. This definition includes five interrelated components:

- *Control environment* sets the tone of an organization, influencing the control consciousness of its staff. It is the foundation for all other internal control components, providing discipline and structure.
- *Risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.
- *Control activities* are the policies and procedures that help ensure management directives are carried out.
- *Information and communication* are the identification, capture, and exchange of information in a form and time frame that enable staff to carry out their responsibilities.
- *Monitoring* is the process that assesses the quality of internal control performance over time.

The objective of our internal control review was to assist the Department in complying with the Financial Integrity and State Managers' Accountability Act of 1983. Specifically, we assisted the Department in determining whether: (1) assets are safeguarded from unauthorized use or disposition; (2) financial transactions are executed in accordance

with management's authorizations and recorded properly to permit the preparation of reliable financial statements; and (3) financial operations are conducted in accordance with State Administrative Manual guidelines, and certain other state laws and regulations, as well as the Department's policies and procedures.

Our review did not include an evaluation of the efficiency or effectiveness of the Department's operations, or the accomplishment of program goals or objectives.

This report is intended for the information and use of the Department management and should not be used for any other purpose. However, the report is a matter of public record and its distribution is not limited.

STAFF:

Susan M. Botkin, CGFM
Manager

Brandon Nunes
Supervisor

Crystal Greenwell
Michael Bratman
Ramon Juarez

EXECUTIVE SUMMARY

During our review of the Department of Alcoholic Beverage Control's (Department) internal control as of January 6, 2005, we identified areas where controls were in place and working as intended, and also identified areas where controls could be improved to reduce the risk of errors, irregularities, and material misstatements. Our findings and observations are summarized below. For further analysis refer to the Findings and Recommendations section of this report.

Administrative Controls: Documentation of policies and procedures are not sufficient to ensure proper control and accountability over the operations of the Department. Specifically, policies and procedures for budgeting, cash disbursements, revolving fund, purchasing, and fixed assets are not adequately documented.

Fixed Assets: Internal control over fixed assets is adequate but could be improved. State assets were adequately safeguarded, and acquisitions and dispositions were properly approved and documented; however, a complete physical inventory has not been conducted or reconciled to the accounting records. In addition the property register is inaccurate.

Information Technology: Internal control over information technology is adequate. Access to accounting and fiscal software and hardware is adequately controlled.

Budget: Controls over the budget functions appear adequate to ensure the reliability and integrity of data. Although the policies and procedures over the budget process are not documented, the Department's budget is developed through input and review from the Fiscal Officer and the Department of Finance Budget Analyst.

Cash Receipts: Internal control over cash receipts is adequate but could be improved. We found delays in remittances to the State Treasurer's Office (STO). Further, we determined that district offices' collections are not adequately safeguarded.

Receivables: Internal control over accounts receivables is adequate. Collection procedures assure appropriate action on outstanding accounts, uncollectible accounts receive appropriate scrutiny prior to write-off, and account adjustments are reviewed, approved, and supported by adequate documentation.

Purchasing: Purchasing controls appear adequate to ensure that purchases are justified, reasonable, consistent with laws and regulations, and that the Department's assets are appropriately safeguarded when received. Although the policies and procedures over the purchasing process are not documented, we observed that purchases of goods and services are proper, economic, and include appropriate authorizations, and that invoices are reviewed and processed promptly and accurately.

Cash Disbursements: Internal control over cash disbursements is adequate but could be improved. Cash disbursements are properly authorized and made only for allowable purposes, and cash disbursement journals, ledgers, and bank accounts are accurately and promptly posted and reconciled. However, stale dated checks are not escheated timely to the STO.

Revolving Fund: Internal control over the revolving fund is adequate but could be improved. The fund has not exceeded the authorized amount and is reimbursed on a timely basis to prevent the fund from being overdrawn. Further, use of funds are for authorized purposes and accountability is maintained. However, travel expense claims are not submitted timely.

Payroll/Personnel: Internal control over personnel and payroll is adequate but could be improved. Payroll expenditures are recorded correctly, stay within budget, and are allocated to the correct fund and program. However, employee leave balances are not adequately monitored.

Contracts: Contracting controls appear adequate. Although the policies and procedures over contract controls are not documented, contracts are supported by appropriate documentation, competitive bidding requirements are followed, and contracts are properly authorized and monitored.

Financial Reporting: Financial reporting controls appear adequate. Required financial statements are properly prepared, certified, and submitted timely.

This report is intended to assist Department management in focusing attention on areas of deficiency, strengthening internal control, and improving operations.



AUDITOR'S REPORT

Mr. Jerry R. Jolly, Director
Department of Alcoholic Beverage Control
3927 Lennane Drive, Suite 100
Sacramento, CA 95834

We have reviewed the Department of Alcoholic Beverage Control (Department) internal control as of January 6, 2005, for conformity with Government Code Section 13400 et seq. Our review included obtaining an understanding of internal control through observations and interviews, testing and evaluating the design and operating effectiveness of the internal control, and performing other procedures we considered necessary.

The Department's management is responsible for establishing and maintaining adequate internal control. This responsibility, in accordance with Government Code Section 13400 et seq., includes documenting internal control, communicating requirements to employees, and assuring that internal control is functioning as prescribed. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of internal control are to provide reasonable, but not absolute, assurance that:

- Assets are safeguarded against loss from unauthorized use or disposition.
- Transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of reliable financial statements.
- Financial operations are conducted in accordance with policies and procedures established in the State Administrative Manual.

Because of inherent limitations in internal control, misstatements due to error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

In reviewing the Department's internal control as of January 6, 2005, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A material weakness is a condition that precludes the Department's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. We believe that none of the reportable conditions is a material weakness. The reportable conditions are described in the *Findings and Recommendations* section of this report.

This report is intended solely for the information and use of Department management and is not intended to be and should not be used by anyone other than this specified party. However, this report is a matter of public record and its distribution is not limited.

Original signed by Diana L. Ducay

Diana L. Ducay, Chief
Office of State Audits and Evaluations
(916) 322-2985

January 6, 2005

FINDINGS AND RECOMMENDATIONS

We reviewed accounting and administrative controls at the Department of Alcoholic Beverage Control (Department) headquarters office, and the Santa Ana, San Diego, San Marcos, Lakewood, and Inglewood district offices as of January 6, 2005. Many controls were functioning as intended; however, we identified areas where controls are either not in place or functioning as intended, and where corrective action is necessary.

Administrative Control

Administrative or managerial controls relate to operational efficiency, adherence to managerial policies, and management's authorization of transactions. Department management is responsible for overseeing activities conducted within their agencies. This responsibility includes the establishment and maintenance of internal accounting and administrative controls over operations. Each system an entity maintains to regulate and guide operations should be documented through flowcharts, narratives, desk procedures, and organizational charts. The following weakness in the Department's administrative controls was identified.

FINDING 1 Inadequate Documentation of Policies and Procedures

Condition: The Department does not maintain adequate documentation describing the policies and procedures associated with the following areas:

- Budgets
- Cash Disbursements
- Office Revolving Fund
- Purchasing and Contracts
- Fixed Assets

Many policies and procedures are not documented and those which are documented are not formalized in a Department approved manual. Failure to adequately document and maintain current policies and procedures in a centralized manual increases the risk of inconsistencies and errors within operational processes, as well as diminishes the Department's training effectiveness should a turnover in staff occur.

Criteria: State Administrative Manual (SAM) Section 20050 states, "the elements of a satisfactory system of internal accounting and administrative controls shall include a system of authorization and record keeping procedures adequate to provide effective

accounting control over assets, liabilities, revenues and expenditures.

Recommendation: Ensure all operational processes and procedures are appropriately documented, revised periodically, and maintained in a centralized manual.

Fixed Assets

Effective internal controls over fixed assets safeguard property, plant, and equipment from unauthorized acquisition, use, or disposition. The following weaknesses in the controls over fixed assets are noted.

FINDING 2 Inadequate Control Over Fixed Assets

Condition: The Department has not performed a complete physical inventory of its property or reconciled this count with its accounting records in the past three years as required by SAM. In addition, the property register is inaccurate. We performed a physical inventory test at the Santa Ana, San Diego, San Marcos, Lakewood and Inglewood district offices. Four out of seven equipment items tested could not be located. In addition, three items were not listed in the property register. Without a complete inventory, the Department is prevented from identifying loss or theft of assets and certifying whether the amounts reported in its general fixed assets account are materially correct.

Criteria: SAM Section 8652 states, "Departments will make a physical count of all property and reconcile the count with accounting records at least once every three years."

Recommendation: Implement procedures to conduct a rotating physical inventory of all headquarters and regional and district office equipment at least once every three years.

Ensure the physical inventory records are reconciled with the accounting records and adjusted accordingly.

Cash Receipts

Effective internal control over the cash receipts process is necessary to ensure that controls are adequate to safeguard cash, and to prevent and timely detect any errors or irregularities. The following weaknesses in the Department's internal control over cash receipts were identified.

FINDING 3 Untimely Remittance to the State Treasurer's Office

Condition: Cash remittances to the State Treasurer (STO) are not made within prescribed time limits. The Department's policy is to remit to the STO every two weeks. However, the Department's daily deposits often exceed the \$25,000 threshold, which would require

remittances to occur on a weekly basis. This practice can result in a loss of interest earnings and the possible material misstatement of the Department's accounting records and financial statements.

Criteria: SAM Section 8091 states, "Regardless of the amount, agencies will remit to the State Treasury all moneys determined to be revenue, reimbursements, abatements, and operating revenue within 30 days following the date collected, unless more frequent remittances are required by law, regulation, or circumstance. Accumulated deposits of \$25,000 will be remitted as soon as possible, but not later than the first day of the week following the accumulation."

Recommendation: Remit deposits as required by SAM.

FINDING 4 Inadequate Safeguarding of Cash Receipts

Condition: The Department's district offices have not maintained adequate controls over cash receipts. We reviewed cash drawer practices at the Santa Ana, San Diego, San Marcos, Lakewood and Inglewood district offices. Four of the five, or 80 percent, district offices did not adequately safeguard cash receipts in a locked drawer or safe during regular business hours. The Inglewood office cash receipts were kept in an in-box and were therefore accessible to all staff.

Criteria: SAM Section 8032.1 states, "When such funds are not in use, they will be locked in a desk, file cabinet, or other mechanism providing comparable safekeeping."

Recommendation: Secure checks, money orders, and cash equivalents in locked drawers, lock box, or safe to prevent theft or loss.

Cash Disbursements

Effective internal control over the cash disbursement process is necessary to ensure that controls are adequate to safeguard cash, and to prevent and timely detect any errors or irregularities. The following weakness in the Department's internal control over cash disbursements was identified.

FINDING 5 Excessive Outstanding Agency Checks

Condition: The Department has not consistently cancelled checks that are outstanding beyond their period of negotiability. As of November 30, 2004, 101 stale dated checks totaling \$14,891 had not been escheated to the STO. Current Department practices are to escheat stale dated checks 18 months after their issue date. Failure to research and escheat checks beyond their period of negotiability results in complex reconciliations and a complicated audit trail.

Criteria: SAM Section 8042 states, "...checks have a one year period of negotiability...Agencies will send Stop Payment Request form, STD 432, to the STO for all uncashed checks timed to arrive at least one week prior to the end of the one-year period of negotiability.

Recommendation: Ensure checks outstanding beyond their period of negotiability are promptly cancelled and escheated, in accordance with the SAM requirements.

Revolving Fund

Effective internal control over the revolving fund is necessary to ensure that the fund has not exceeded the authorized amount, is reimbursed on a timely basis to prevent the fund from being overdrawn, use is for authorized purposes, and accountability is maintained. The following weakness in the Department's internal control over the revolving fund was identified.

FINDING 6 Travel Expense Claims are Not Submitted Timely

Condition: Travel expense claims (TEC) are not submitted to the fiscal management unit for payment within 30 days after the date of travel. Out of 20 TEC's, 7, or 35 percent, were not submitted timely. These were submitted 34 to 190 days after travel was completed. As a result, travel advances were not cleared timely.

Criteria: SAM Section 8116.2 states, "A properly prepared travel expense claim to substantiate the travel expenses must be submitted as soon as possible after the trip(s) or at least once a month."

Recommendation: Monitor employee travel on a regular basis to ensure TECs are submitted timely and advances are cleared timely.

Personnel/Payroll

Effective internal control over the personnel and payroll functions is required to ensure that Department staff are properly appointed, staff are not separated with outstanding advances or in possession of Department assets, and payroll information is processed accurately and timely. The following weakness in the controls over personnel and payroll was noted.

FINDING 7 Inadequate Monitoring of Employee Leave Balances

Condition: The Department does not adequately monitor employee leave balances. Out of 21 employees tested, 11, or 53 percent, had balances exceeding the maximum accumulation of leave balances allowed.

- Criteria: Department of Personnel Administration regulations state that an employee is allowed to accumulate a maximum of 640 hours of annual leave and 400 hours of vacation hours.
- Recommendation: Monitor employee leave balances to ensure authorized levels are not exceeded. Establish vacation schedules and monitor immediately for those employees over the maximum leave allowed.

CONCLUSION

Our review of the Department of Alcoholic Beverage Control's (Department) internal control presents opportunities for the Department's management to correct identified weaknesses and improve its operations. Internal controls would be strengthened and the Department would operate more efficiently and effectively if management implements our recommendations. The internal control weaknesses, if left uncorrected, increase the risk that material errors or irregularities could occur and remain undetected and could affect the accuracy of the Department's financial statements.

The findings in this report are based on fieldwork performed between November 15, 2004 and January 6, 2005. We presented these findings and non-reportable issues to the related divisions and units at the completion of each cycle, at the interim pre-exit meeting, and finally during our exit conference on January 13, 2005.

DEPARTMENT'S RESPONSE

Memorandum

To: Janet I. Rosman, Assistant Chief,
Office of State Audits and Evaluations
Department of Finance
915 L Street
Sacramento, CA 95814

Date: December 12, 2005

From: Department of Alcoholic Beverage Control
Director's Office
3927 Lennane Drive, Suite 100
Sacramento, CA 95834

Subject: **Response to Internal Control Review Report**

Thank you for the opportunity to review and comment on the internal control draft report prepared by your staff.

Our response is simple and straightforward: we concur with all the findings and agree your recommendations will enable us to establish and maintain better internal and administrative controls. In fact, we are in the process of developing plans to implement the specific recommendations and we intend to provide an update on our progress in approximately four months. We believe your report is very instructive for our new Fiscal Officer and a useful management tool to ensure compliance.

I would also like to commend and compliment the audit team assigned to this review. Ms. Crystal Greenwell, Mr. Ramon Juarez and Mr. Michael Bratman were very professional and their competency and knowledge is exceptional.

If you have any questions or need additional information, please contact with myself or Dennis Clear, our Assistant Director for Administration at (916) 419-2511.

Original signed by Jerry R. Jolly

Jerry R. Jolly
Director

Cc: Sunne Wright McPeak, Secretary,
Business, Transportation and Housing Agency